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# **PLIGHT OF THE NON-DEBTOR TENANT: A RELEVANT INTEREST IN A BANKRUPTCY PROCEEDING**

BENJAMIN J. CASPER\*

## **INTRODUCTION**

Imagine you are the owner of a popular sporting goods shop in the local mall. Your business is booming, thanks in part to the foresight you had to ensure your store lease provided you with the exclusive right to sell sporting goods in the mall. Not so lucky was a neighboring tenant, whose toy store fell on hard times, forcing him to declare bankruptcy. A few months later you are dismayed to find out that your neighbor's bad fortune is also bad luck for you because suddenly the toy store has been replaced by another sporting goods store. Regardless of whether your landlord had objections to this new tenant, a court determined that releasing the toy store of its lease in this manner was a necessary step in attempting to help the owner out of bankruptcy. In doing so, the court completely disregarded the effects that the presence of this new competitor might have on your business. A glaring issue thus surfaces: Should you be punished for someone else's shortcomings, without being given a chance to voice your objections? This is the type of situation that can face a shopping center tenant when a fellow tenant's attempt at reorganization ultimately disadvantages the solvent tenant's operation of its business. In such a circumstance, the Bankruptcy Code does not explicitly urge courts to consider the interests of third parties that might be adversely affected.

In general, the Code grants a significant amount of power to a party that has been forced to file for bankruptcy.<sup>1</sup> Section 365(a) of the Code gives the trustee (or debtor in possession) power to assume, reject or assign

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<sup>1</sup> Section 365 of the Bankruptcy code states that except as provided by certain other sections of the Code, "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C.S § 365(a) (2009).

executory contracts.<sup>2</sup> In the context of bankruptcy law, an executory contract is understood to mean contracts under which neither party has materially performed.<sup>3</sup> The debtor's ability to shed itself of a burdensome executory contract or replace the contract with a more profitable arrangement can be a useful tool in reorganizing.<sup>4</sup> This power to assign an executory contract, however, can be complicated in a situation where assignment of the contract affects third parties. If a debtor tenant, while attempting to reorganize after filing for bankruptcy, is permitted to assign its lease to another tenant, the result could amount to a violation of a non-debtor tenant's exclusivity provision, a disruption of the tenant makeup of the shopping center, and an economic encumbrance on the non-debtor tenant's business due to the presence of a new competitor.

This note will focus on the issues involved in the rejection of an exclusive use clause and the standards by which a rejection should be evaluated by a court. It will argue that non-debtor tenants should have legal standing to object to debtor-tenant's lease assignments. Finally, this note will argue that the legislative history of section 365 and bankruptcy issues arising in other arenas similar to shopping centers lend strong support to the contention that bankruptcy courts should consider the interests of third party, non-debtor tenants in deciding both whether to approve a given lease assignment and whether a debtor or assignee can violate a restrictive use clause in a shopping center lease.

Part I provides background on the rights granted to a debtor after filing for bankruptcy under Chapter 11. Part II discusses three key cases on the subject of a debtor-tenant assigning leases in a bankruptcy proceeding, the manner in which courts have dealt with tenants that seek to reject restrictive use provisions, and the trends courts are following in giving landlords an increasing amount of power in bankruptcy proceedings. Part III argues that there is ample evidence both in the Code and in case law that suggests that interests of a non-debtor tenant were intended to be protected

<sup>2</sup> COLLIER ON BANKRUPTCY ¶ 365.03 (Allan N. Resnik & Henry J. Sommer eds., Matthew Bender & Company, Inc., 15th ed. rev. 2009). "Section 365(a) sets forth the basic power of the trustee to assume or reject executory contracts and unexpired leases." *Id.*

<sup>3</sup> *Id.* ¶ 365.02[1]. "Once contracts fully performed on one side or the other are eliminated, only contracts materially unperformed on both sides remain. These are the contracts that are generally considered to be executory contracts in bankruptcy." *Id.*; See BLACK'S LAW DICTIONARY (8th ed. 2004). "A contract that remains wholly unperformed or for which there remains something still to be done on both sides, often as a component of a larger transaction and sometimes memorialized by an informal letter agreement, by a memorandum, or by oral agreement."

<sup>4</sup> See *id.* ¶ 365.03[2] (discussing scenarios in which courts have allowed a debtor to reject an executory contract); See also *In re Waldron*, 65 B.R. 169, 171 (Bankr. N.D. Tex. 1986) ("[T]he assumption or rejection of executory contracts . . . is a valuable weapon of the Trustee meant to free the estate to pay larger dividends to the general creditors.").

from the effects of a fellow tenant's bankruptcy, and that the Code should explicitly codify this position.

## I. BACKGROUND: BANKRUPTCY CODE SECTION 365 AND EXECUTORY CONTRACTS

This part discusses the basic background for understanding executory contracts and the options that the Code provides to the debtor party in a bankruptcy proceeding. Part I.A describes the generally-held understanding of an executory contract, and Part I.B explores the standards that courts use in considering a debtor's assumption or rejection of an executory contract.

### A. *What is an executory contract?*

One of the most significant powers granted to a debtor that has filed for bankruptcy is the debtor's right to decide the fate of executory contracts, that is: contracts that remain unperformed.<sup>5</sup> As important as this power is, the Bankruptcy Code does not provide a definition of an *executory contract*.<sup>6</sup> The majority of Federal Courts<sup>7</sup> have adopted a definition set forth by the famous commentator and scholar, Professor Vern Countryman, and define an executory contract as an agreement where "the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."<sup>8</sup> These courts hold that if one party has materially performed its side of the bargain, then the contract can no longer

<sup>5</sup> See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984) ("Thus, the authority to reject an executory contract is vital to the basic purpose of a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization."); cf. *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 742 (1996) ("Rather, the executed portions of the contract remain intact, and property rights acquired under the contract prior to filing became property of the estate despite the trustee's rejection of unperformed obligations of the contract.") (citing *In re Tomer*, 128 Bankr. 746, 756 (Bankr. S.D. Ill. 1991), *aff'd*, 147 Bankr. 461 (S.D. Ill. 1992)).

<sup>6</sup> *NLRB*, 465 U.S. at 523 n.6 ("The Bankruptcy Code furnishes no express definition of an executory contract."); COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 365.02[1] ("However, the section does not define the term 'executory contract.'").

<sup>7</sup> DANIEL J. FLANIGAN, *Executory Contracts: Structuring, Drafting, Planning, and Execution in, and in Anticipation of, Financial Restructuring and Bankruptcy*, in UNDERSTANDING THE LEGAL ISSUES BEHIND EXECUTORY CONTRACTS IN BANKRUPTCY: LEADING LAWYERS ON STRATEGIES FOR THE STRUCTURING, DRAFTING, AND EXECUTION OF EXECUTORY CONTRACTS, 6 (Aspartore, Inc., 2006). See also, *Oil and Gas Leases and Section 365 of the Bankruptcy Code: A Uniform Approach*, 63 AM. BANKR. INST. L. REV. 337, 341-42 (1989) ("The definition applies by a substantial majority of courts that have considered executory contract issues is that put forward by Professor Countryman.") *Id.*

<sup>8</sup> Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1974).

be considered executory and the debtor would no longer have the right to assume or reject an outstanding contract.<sup>9</sup> In the event that a contract is considered executory, section 365(a) authorizes the trustee to assume or reject the executory or unexpired lease, subject to court approval.<sup>10</sup>

*B. Standards for determining a trustee's decision to assume or reject*

In most bankruptcy cases, courts use a "business judgment" test in evaluating a debtor's decision to assume or assign an executory contract.<sup>11</sup> The business-judgment rule provides that "[a]s long as assumption [or rejection] of a lease appears to enhance a debtor's estate, court approval of a debtor-in-possession's [(DIP)] decision to assume the lease should only be withheld if the debtor's judgment is clearly erroneous, too speculative, or contrary to the provisions of the Bankruptcy Code. . . ."<sup>12</sup> The court must determine if the debtor's estate would be benefited or burdened by the assumption of the executory contract.<sup>13</sup> This test focuses only on the interests of the bankrupt estate, essentially ignoring the interests of the non-debtor party to the executory contract and ignoring any third-party interests in the contract.<sup>14</sup> The "business judgment" therefore embodies Professor Countryman's view that the right to reject should be used when it will benefit the bankrupt estate.<sup>15</sup>

<sup>9</sup> See Flanigan, *supra* note 7, at 6.

<sup>10</sup> 11 U.S.C. § 365(a) (2009).

<sup>11</sup> Orion Pictures Corp., v. Showtime Networks, Inc., 4 F.3d 1095, 1099 (2d Cir. 1993) (noting that "a bankruptcy court . . . should examine a contract and the surrounding circumstances and apply its best 'business judgment' to determine if it would be beneficial or burdensome to the estate to assume it."); COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 365.03[2] (asserting that, while a court should use its best judgment, it should "focus on the business judgment of the trustee or debtor in possession, not on its own business judgment.").

<sup>12</sup> See Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1309 (5th Cir. 1985) (citing Allied Tech. Inc. v. R.B. Brunemann & Sons, 25 B.R. 484, 495 (Bankr. S.D. Ohio 1982)).

<sup>13</sup> See Orion Pictures, 4 F.3d at 1099 (noting that a court must determine "whether assuming the contract would be a good business decision or a bad one."); see also COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 365.03[2] (indicating that courts use their "best business judgment" to see whether an assumption is beneficial).

<sup>14</sup> See William L. Medford & Bruce H. White, *Rejecting Executory Contracts: Is the Standard Changing?*, 23-8 AM. BANKR. INST. J. 24, 24 (2004). "Thus, more often than not, there is little a non-debtor party can do in response to a motion to reject other than file or amend its proof of claim." *Id.* See generally Douglas W. Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L.J. 197, 200 (1985). "It therefore appears that, during the period from the date of filing until the date on which the DIP rejects or assumes an executory contract, the non-debtor party is bound to perform . . ." *Id.*

<sup>15</sup> See Countryman, *supra* note 8, at 450. "Similar to the [trustee's] general power to abandon or accept other property, this is an option to be exercised when it will benefit the estate."; see also Juliet M. Moringiello, *A Mortgage By Any Other Name: A Plea For The Uniform Treatment Of Installment Land Contracts And Mortgages Under The Bankruptcy Code*, 100 DICK. L. REV. 733, 787-88 (1995-96). "A trustee should only assume a contract when the assumption will benefit the estate." *Id.*

For certain types of agreements, some courts have adopted a higher standard of review of a debtor's decision to assume or reject executory contracts.<sup>16</sup> A number of executory contracts, such as collective bargaining agreements (CBAs), may raise issues that affect public interest and are therefore subject to application of a higher standard of judicial scrutiny.<sup>17</sup> The Supreme Court in *NLRB v. Bildisco & Bildisco*<sup>18</sup> created a "more rigorous standard" that involved balancing all the relevant equities before approving or denying the debtor's rejection. Bildisco was a building supplies distributor that filed for Chapter 11 reorganization on April 14, 1980.<sup>19</sup> Prior to the filing of the bankruptcy petition, Bildisco had negotiated a three-year CBA with the union that represented approximately 45% of its employees.<sup>20</sup> In May of 1980, Bildisco, as a DIP, breached the CBA by refusing to pay wage increases pursuant to the agreement.<sup>21</sup> The bankruptcy court ultimately approved Bildisco's application to reject the CBA, and the district court affirmed the rejection order.<sup>22</sup> Ultimately, the issue reached the Supreme Court and, on certiorari, the Court considered the criteria to be applied by a bankruptcy court in allowing a DIP to reject a CBA. Writing for a unanimous decision on this issue, Justice Rehnquist stated that, "[d]etermining what would constitute a successful rehabilitation involves balancing the interests of the affected parties – the debtor, creditors, and employees."<sup>23</sup> The Court in *Bildisco* reiterated what the Supreme Court and other courts have previously noted in other cases about the "special nature"<sup>24</sup> of CBAs.<sup>25</sup> As one case noted, a CBA is more than just a contract; it is a generalized code that sets the laws for a particular industry or company, functioning as a guide to a multitude of cases, each

<sup>16</sup> *E.g.*, *Mirant Corp. v. Potomac Elec. Power Co.*, 378 F.3d 511, 525 (5th Cir. 2004) (stating that the "[u]se of the business judgment standard would be inappropriate in this case because it would not account for the public interest inherent in the transmission and sale of electricity.").

<sup>17</sup> *See id.*; *see also* *Medford & White*, *supra* note 14, at 24 (suggesting that "a stricter standard should apply to the executory contract rejection analysis when the contract in issue affects the public interest.").

<sup>18</sup> 465 U.S. 513, 526 (1984). "The standard which we think Congress intended is a higher one than that of the 'business judgment' rule . . ." *Id.*

<sup>19</sup> *NLRB*, 465 U.S. at 517.

<sup>20</sup> *Id.* at 517–18.

<sup>21</sup> *Id.* at 518.

<sup>22</sup> *Id.* .

<sup>23</sup> *Id.* at 527.

<sup>24</sup> *Id.* at 524.

<sup>25</sup> *Id.* (citing to two Supreme Court cases and a number of Courts of Appeals decisions that recognized the special nature of a collective bargaining agreement and decided that evaluation of a rejection of a collective bargaining agreement should be governed by a stricter standard than the "business judgment" test).

with its own unique and unpredictable set of issues.<sup>26</sup> The *Bildisco* case serves as an example of a court applying a higher standard than merely considering whether an agreement benefits or burdens an estate. Specifically, the Court considered the effect of a debtor's rejection on third parties.<sup>27</sup>

Another key case positing a higher standard of review was a Fifth Circuit decision in *Mirant Corp. v. Potomac Elec. Power Co.*<sup>28</sup> Mirant Corporation was one of the largest regulated public utilities that generated, bought, and sold electricity for use by other utilities, municipalities, and generators across the country.<sup>29</sup> In July 2003, Mirant filed for Chapter 11 bankruptcy and sought to reject a purchasing schedule for electricity that was part of the larger asset purchase agreement.<sup>30</sup> The scheduling contract had been entered into because Potomac Electric Power Co. ("Potomac"), the seller, was concerned that it might have difficulty assigning certain power purchase agreements.<sup>31</sup> Although the contract was initially lucrative, Mirant later wanted to reject the contract because the rates charged in the contract had become higher than the market rates.<sup>32</sup> The district court denied Mirant's motion to reject the scheduling contract.<sup>33</sup> On appeal, the Fifth Circuit noted that this contract for the sale of electricity at wholesale was unique in nature.<sup>34</sup> Similar to the collective bargaining agreements in *Bildisco*, a significant public interest existed for contracts involving the transmission and sale of electricity.<sup>35</sup> On remand, the Fifth Circuit instructed the district court to "consider applying a more rigorous standard

<sup>26</sup> *United Steelworkers of America v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 578–79 (1960) (describing CBAs and their importance to contractual relationships); see Harry Shulman, *Reason, Contract, and Law in Labor Relations*, 68 HARV. L. REV. 999, 1004–05 (1955) (discussing the intricate provisions of a CBA that govern the relationship between employers and employees).

<sup>27</sup> Later in this note, the author will suggest that real estate leases and covenants are similar to CBA's and should be subject to the same type of scrutiny.

<sup>28</sup> 378 F.3d 511 (5th Cir. 2004).

<sup>29</sup> *Mirant*, 378 F.3d at 515.

<sup>30</sup> *Id.* at 516 (explaining that Mirant filed a motion to reject the purchasing schedule, which the parties and the court referred to as the Back-to-Back Agreement).

<sup>31</sup> *Id.* at 515 (noting that the parties agreed that any of the purchase power agreements Potomac could not obtain consent to assign would be governed by the terms of the schedule, and that Mirant would purchase from Potomac an amount of electricity equal to Potomac's obligation under the unassigned purchase power agreements and at the same rate specified in those contracts).

<sup>32</sup> *Id.* at 515–16 (stating that the high rates specified in the contract caused Mirant significant financial losses).

<sup>33</sup> *Id.* at 516–17 (positing Mirant's motion was denied because the district court did not have authority to reject the agreement).

<sup>34</sup> *Id.* at 525 (explaining that an interstate contract of this kind is unique).

<sup>35</sup> *Id.* (drawing a comparison to the public interest oriented rationale employed by the Supreme Court in its ruling on the *Bildisco* case).

to the rejection” of the agreement.<sup>36</sup> The *Mirant* court stated that the business judgment standard was inappropriate under the circumstances, and that a stricter standard should be used in analyzing a rejection of an executory contract when the contract affects public interest.<sup>37</sup> Therefore, the *Bildisco* and *Mirant* holdings suggest that certain petitions for rejection of executory contracts are subject to elevated standards that consider the effects rejection would have on third parties.

## II. THE BALANCE OF POWER AMONG LANDLORDS AND TENANTS

This part discusses three cases involving debtor-tenants assigning or rejecting leases after filing for bankruptcy. Part II.A focuses on a fairly recent case that interpreted section 365 in a way that has given landlords significantly more power than they had previously granted to oppose a debtor-tenant’s assignment or rejection of a lease. This part also examines a balancing test used by a number of bankruptcy courts in connection with a debtor’s attempt at disregarding restrictive use clauses in a lease it seeks to assign. Part II.B critiques a decision that failed to properly consider the interest of a non-debtor tenant and points out that the courts’ improper reading of the Code could set a dangerous precedent for future cases.

### *A. Limitations on assignments and restrictions contained in leases are meant to be followed*

When two parties enter into a contract, there is a general expectation that the terms of the contract will be upheld and followed. Commercial leases between shopping center landlords and tenants are no different, each having certain goals in mind when contemplating a lease. This is especially true due to the carefully planned nature of a shopping center and the importance for the landlord and tenants to maintain a good tenant mix.<sup>38</sup> A landlord will generally lease commercial space only to a carefully selected group of tenants.<sup>39</sup> To preserve the desired tenant mix, shopping

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 525 (borrowing the language of the standard set forth in *Bildisco* and applying it to the scheduling contract in this case); Medford, *supra* note 14, at 63 (summarizing the *Mirant* court’s view that the facts of the case necessitated a more rigorous standard than the usual business judgment test in evaluating *Mirant*’s motion to reject).

<sup>38</sup> See *infra* text accompanying notes 94–97 (discussing the unique characteristics of a shopping center).

<sup>39</sup> See Lisa S. Gretchko, *Last in Line: Debtor Beware! Fourth Circuit Enforces Restrictive Use Clause to Block Debtor/Tenant’s Assignment of Shopping Center Lease*, 23-7 AM. BANKR. INST. J. 18, 18 (2004) (noting that this is important in preserving tenant mix and maintaining control over their property); see also Alan S. Gover & Ian J. Silverband, *Phoenix Coyotes Bankruptcy Can Still Be Model*



center leases typically contain anti-assignment clauses and/or restrictive use clauses.<sup>40</sup> For many years, tenants filing for bankruptcy were able to sidestep anti-assignment clauses contained in their leases.<sup>41</sup> This power to do so was seemingly granted by section 365(f)(1), which contains a general provision that prohibits the enforcement of “anti-assignment” clauses in leases.<sup>42</sup> This section allows a debtor tenant to assign a lease “notwithstanding a provision . . . that prohibits, restricts or conditions . . . assignment.”<sup>43</sup> The effect of this provision has allowed millions of dollars of value in shopping center leases to be transferred to the tenants’ creditors, despite the objections of numerous shopping center owners.<sup>44</sup> The transfer of these leases can cause extensive damage to the tenant makeup of a shopping center.<sup>45</sup>

A recent case in 2004 marked a tremendous victory<sup>46</sup> for landlords on two separate but related grounds. The Fourth Circuit in *Trak Auto Corp. v. West Town Center, LLC*<sup>47</sup> clarified how to proceed with a lease containing an anti-assignment clause as it relates to two seemingly contradictory provisions in the Code.<sup>48</sup> In addition, the *Trak Auto* court provided guidance in situations involving a debtor’s attempt at disregarding a

*For Troubled Sports Franchises*, 27 ENT. & SPORTS LAW. 4, 8 (Fall 2009) (explaining that a proper tenant mix in a shopping center is desirable because it promotes healthy revenues).

<sup>40</sup> Gretchko, *supra* note 39, at 18; Thomas J. Leanse & Dustin P. Branch, *What’s the Use?: Court Protects Retail Landlords’ Rights to Control Reassigned Leases*, COMMERCIAL INVESTMENT REAL ESTATE, Sept./Oct. 2004, available at [http://www.ciremagazine.com/article.php?article\\_id=101](http://www.ciremagazine.com/article.php?article_id=101) (discussing the landlord’s right to control tenant mixes by use provisions). The author will go into further detail about the importance of maintaining the agreements in the lease (as mentioned in 365(b)(3)(C)) and maintaining the tenant mix (as mentioned in 365(b)(3)(D)) in a shopping center in Part III of this Note.

<sup>41</sup> See Harris Ominsky, *Shopping Centers: Use Clauses Must Be Honored in Tenants’ Bankruptcies*, 24 SHOPPING CENTER LEGAL UPDATE 13, 13 (Summer 2004) (citing a recent victory in the fight for a landlord’s right to “enforce lease restrictions on use, alterations, and other operating issues in shopping center leases.”); Stephen A. Bogorad, *Retail Bankruptcy: Is it a License for an Anchor to “Go Dark?”*, BANKR. AND CRED. RIGHTS (Holland and Knight, Washington, D.C.), Dec. 1, 1999, at ¶ 4, <http://www.hklaw.com/id24660/PublicationId1593/ReturnId31/contentid47442/> (noting that “shopping center landlords often find themselves on the defensive in retail bankruptcy cases, most commonly in connection with proposed lease assignments.”).

<sup>42</sup> See 11 U.S.C. § 365(f)(1) (2009).

<sup>43</sup> *Id.*

<sup>44</sup> Ominsky, *supra* note 41, at 13.

<sup>45</sup> See *id.* “Pursuant to congressional hearings in 1984, Congress concluded that the practice of avoiding use restrictions in bankruptcy was creating problems with tenant mix and adversely affecting shopping centers.” *Id.*; Bogorad, *supra* note 41, at 13. “Proposed lease assignments pose the greatest problems when the debtor tenant is an anchor of a shopping center.” *Id.*

<sup>46</sup> Leanse & Branch, *supra* note 40, ¶ 3. “The *Trak Auto* decision represents an important victory for shopping center landlords by emphasizing Section 365(b)(3)(C)’s role in retail bankruptcies.” *Id.*

<sup>47</sup> 367 F.3d 237 (4th Cir. 2004) (barring a debtor-tenant from assigning its shopping center lease in contravention of a provision that limits use of the premises to the sale of auto parts).

<sup>48</sup> See *Trak Auto Corp.*, 367 F.3d at 243–44; see also *infra* text accompanying note 52–61 (detailing the court’s analysis of the two contradictory provisions in section 365 of the Code).

restrictive use clause in a lease.<sup>49</sup> Trak Auto was an auto part retailer that filed for bankruptcy which, in an effort to reorganize its business, sought to assign a number of its leases of retail space.<sup>50</sup> One of the retail spaces it sought to assign was located in a Chicago shopping center called West Town Center.<sup>51</sup> The lease required that the space be used for the sale of automobile parts and accessories.<sup>52</sup> Trak Auto began soliciting bids for the lease but was unable to secure an auto parts dealer, and instead sought to assign the lease to an apparel merchandiser for \$80,000.<sup>53</sup> Much to the dismay of the landlord, the bankruptcy court approved the assignment, concluding that the anti-assignment provision violated 356(f)(1) of the Bankruptcy Code and that West Town did not provide sufficient evidence that assignment of the lease to the apparel merchandiser would disrupt the tenant mix of the shopping center.<sup>54</sup> The district court subsequently affirmed the bankruptcy court's ruling and West Town appealed to the Fourth Circuit.<sup>55</sup>

On appeal, the Fourth Circuit overturned the bankruptcy court and held that West Town's interest in preserving its tenant mix and enforcing the restrictive use clause in its lease with Trak Auto should be upheld, and that Trak Auto's motion for assignment should have been denied.<sup>56</sup> The court first wrestled with the issue of what Code provisions govern a lease assignment in shopping center.<sup>57</sup> The court's analysis is of particular significance because it helped resolve two ostensibly contradictory provisions in the Code.<sup>58</sup> Section 365(f)(2)(B) allows a debtor to assign an

<sup>49</sup> See 367 F.3d at 244–45, and *infra* text accompanying notes 62–73 (explaining the balancing used by the court relating to the lease's restrictive use clause).

<sup>50</sup> See *Trak Auto Corp.*, 367 F.3d at 240.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* at 241. After the Fourth Circuit granted a stay, West Town filed a motion to dismiss its own appeal as moot since the lease it had with Trak Auto had expired. The Fourth Circuit was ruling on this motion in this decision. *Id.*

<sup>56</sup> *Id.* at 244–45. The Fourth Circuit held that West Town was free to enforce the remaining restriction that limits the use of the premises to the retail sale of auto parts and accessories. *Id.* at 244. The court reasoned that shopping center leases are in a special category, and shopping center landlords are provided special protection under § 365(b)(3)(C). *Id.* at 245. However, the court also explained that a shopping center lease provision designed to prevent any assignment whatsoever might be a candidate for invalidation under § 365(f)(1). *Id.*

<sup>57</sup> See *id.* at 243 (noting the two relevant provisions: § 365(f)(1) and § 365(b)(3)(C)).

<sup>58</sup> See *id.* (explaining how § 365(f)(1) is a general provision that permits lease assignment notwithstanding anti-assignment clauses and § 365(b)(3)(C) is a more specific provision that requires the assignee of a shopping center lease to honor a clause restricting the use of the premises); see also Ominsky, *supra* note 41, at 13 (discussing the conflict in the Code and how the court resolved the issue).

unexpired lease if the assignee provides “adequate assurance of future performance . . . .”<sup>59</sup> The Code lists a number of ways to provide adequate assurance, one of which is assurance that the assignment “is subject to all the provisions of the lease, including (but not limited to) provisions such as a radius, location, use or exclusivity provision.”<sup>60</sup> Furthermore, the assignment cannot breach any such provision contained in any other lease or agreement relating to the shopping center.<sup>61</sup> The seemingly conflicting provision is the general provision found in section 365(f)(1), which prohibits the enforcement of “anti-assignment” clauses in leases.<sup>62</sup>

On the one hand, it seems the debtor (and its assignee) must provide adequate assurance that it will comply with provisions of the lease. On the other hand, the Code restricts the enforcement of the landlord’s clauses contained in the lease, allowing the debtor to assign the lease notwithstanding a provision that might restrict assignment, absent receiving adequate assurance from the debtor’s assignee.<sup>63</sup> The *Trak Auto* court explained that according to canons of statutory construction, section 365(b)(3) trumps the more general legislative provision of section 365(f)(1) which intended to prohibit anti-assignment clauses.<sup>64</sup> Section 365(b)(3)(C)<sup>65</sup> is more specific because it directly relates to shopping

<sup>59</sup> 11 U.S.C. § 365(f)(2)(B) (2009). “The trustee may assign an executory contract or unexpired lease of the debtor only if . . . adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.”

<sup>60</sup> 11 U.S.C. § 365(b)(3) (2009). Section 365(b)(3) provides:

For the purposes of paragraph (1) of this subsection and paragraph (2)(B) of subsection (f), adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance—

(A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

*Id.*

<sup>61</sup> *Id.*

<sup>62</sup> 11 U.S.C. § 365(f)(1) (2009).

<sup>63</sup> See *Trak Auto Corp.*, 367 F.3d at 241 (contrasting two provisions of the Bankruptcy Code); see also *In re Fleming Co.*, 499 F.3d 300, 305 (3d Cir. 2007) (noting that “adequate assurances need not be given for every term of an executory contract.”).

<sup>64</sup> *Trak Auto Corp.*, 367 F.3d at 243–44 (“When two provisions in a statute are in conflict, ‘a specific [provision] closely applicable to the substance of the controversy at hand controls over a more generalized provision.’”) quoting *Sigmon Coal Co. v. Apfel*, 226 F.3d 291, 302 (4th Cir. 2000)).

<sup>65</sup> 11 U.S.C. § 365(b)(3) provides:

centers and therefore controlled in the case of Trak Auto's lease.<sup>66</sup> Also, the legislative history weighed in favor of giving the landlord the power to prevent an unwanted lease assignment, as evidenced by Congress's 1984 amendments to the Code, which put shopping centers in its own category to make it more difficult for debtor-tenants to assign leases.<sup>67</sup>

The court next submitted an approach to determine the fate of a restrictive use clause in a lease and whether it should survive a debtor's attempt at assignment. The court balanced the reasonableness of the debtor's assignment against the harm or effect it would have on the landlord.<sup>68</sup> In finding that the restrictive use clause in the debtor's lease should be enforced, the court explained that the landlord's right to choose its tenant mix and the court's reluctance to challenge that right outweighed the debtor's interest in violating the clause.<sup>69</sup> Furthermore, the restrictive clause was not so restrictive as to constitute a *de facto* anti-assignment clause that would be unenforceable under section 356(f)(1).<sup>70</sup> Therefore, the court said, "[s]ection 365(b)(3)(C) simply does not allow the

For the purposes of paragraph (1) of this subsection . . . adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance—

(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; . . .

*Id.*

<sup>66</sup> See *Trak Auto*, 367 F.3d at 244 (noting that 11 U.S.C. § 365(b)(3)(C) controls under the court's use of a canon of statutory construction).

<sup>67</sup> See *id.* at 243 (detailing Congress's 1984 amendments of the shopping center provisions); *In re Rickel Home Centers, Inc.*, 209 F.3d 291, 299 n.8 (3d Cir. 2000) (explaining the purpose of the 1984 amendments to the Bankruptcy Code).

<sup>68</sup> See *Trak Auto*, 367 F.3d at 244 (discussing the landlord's judgment regarding a mix of stores and the ability of a debtor to assign a lease regardless of market conditions).

<sup>69</sup> *Id.* The Court noted the shopping center landlord's desire for a successful mix of stores. *Id.*; see *In re Federated Dep't Stores, Inc.*, 135 B.R. 941, 941–46 (Bankr. S.D. Ohio 1991). Here, the court denied a debtor's assignment of a retail department store lease to a "specialty" department store geared toward the more frugal consumer, because the department store was an "anchor store." Accordingly, the store was a staple of the shopping center and the central component of the shopping center's tenant mix. Allowing assignment of this lease would disrupt the tenant mix of the shopping center and would make the shopping center less appealing to the more upscale clientele the landlord hoped to attract. The Court's balancing test weighed heavily in favor of the landlord's interest in preserving the use provision requiring a high-end department store as the tenant in that space); see *In re J. Peterman Co.*, 232 B.R. 366, 369–70 (Bankr. E.D. Ky. 1999). A proposed assignee of a lease was not going to comply with a use and radius clause that specifically required the premises be operated under the "J. Peterman" brand name within 60 miles of the shopping center. The court determined that the 60-mile radius was a "bargained for exchange," and that it was reasonable in the circumstances being that this upscale discount center was strategically located within short driving distance of New York City. The court did not find enough of a reason weighing against its enforcement, so it remained a provision of the lease upon any assignment, and the court denied approval of the assignment to the tenant that refused to honor the restriction.

<sup>70</sup> *Trak Auto*, 367 F.3d at 244.

bankruptcy court or [this court] to modify West Town's 'original bargain with the debtor.'"<sup>71</sup>

The court's reluctance to classify the restrictive clause as *overly* restrictive demonstrates the difficulty a debtor will have to now argue, using the general provision in section 365(f)(1), that a restrictive use clause is so restrictive that the clause can be ignored when the debtor attempts to assign its lease. That being said, while the *Trak Auto* decision marked a substantial victory for shopping center landlords, the court clearly stated the importance of maintaining focus on assisting the bankrupt entity in recuperating after filing for bankruptcy.<sup>72</sup> *Trak Auto* did not undermine this central objective of the Code to help the debtor reorganize; rather, it simply recognized the importance of other competing factors. The case of *In re Rickel Home Centers Inc.*,<sup>73</sup> another Fourth Circuit opinion, is often cited in defense of a debtor's rights to reject executory contracts. It is important to note that *Trak Auto* does not overrule that decision. In *Rickel*, the court upheld a tenant's ability to reject specific use clauses, ruling that the use provisions in the leases constituted a *de facto* anti-assignment clauses and invalidated those provisions. Rickel, the debtor, was a home-improvement store operator that sought to assign its many shopping center leases to Staples, the office-supply store chain.<sup>74</sup> Vornado, the owner of one of the shopping centers where Rickel was located, sought to enforce a provision in Rickel's lease that limited the tenant use to a "Home Improvement Center."<sup>75</sup>

The *Rickel* court's decision to strike the anti-assignment provisions from the leases based on section 365(f)(1)<sup>76</sup> can be understood in concert with the *Trak Auto* ruling that gave deference to the more specific provision of section 365(b)(3) because the two cases are factually distinguishable. The major distinction between the facts of *Trak Auto* and *Rickel* is that in *Rickel* the market for the type of "home improvement center" referred to in the lease had become "non-existent or in dire straits."<sup>77</sup> As a result, the debtor tenant was essentially precluded from assigning the lease because the lease

<sup>71</sup> *Id.* (quoting S. REP. NO. 98-65, at 67-68 (1983) (emphasis added)).

<sup>72</sup> *See id.* at 244. "Our decision to block *Trak Auto*'s lease assignment is not an attempt on our part to water down one of the important purposes of Chapter 11. That purpose is to give business debtors with some prospects the opportunity to reorganize, revive their operations, and continue in existence." *Id.*

<sup>73</sup> 240 B.R. 826 (D. Del 1998).

<sup>74</sup> *Id.* at 828.

<sup>75</sup> *Id.* at 831.

<sup>76</sup> *See id.*

<sup>77</sup> *Id.* at 832.

forced an assignment to a type of business enterprise that no longer existed.<sup>78</sup> The *Rickel* court correctly upheld the Code's concern for the tenant and protected the tenant from remaining trapped with a lease restriction that could not be met. In *Trak Auto*, by contrast, the use provision that the tenant space be used to sell auto parts was upheld because, while the court found that assigning to another auto part owner at that particular time would have been *difficult* and perhaps *uneconomical* since there were a number of other auto part stores in the area, the lease restriction did not make an assignment *impossible*.<sup>79</sup> It simply meant that the debtor might encounter problems abiding by the use restriction *at that time*. There was no reason, however, to think that the lease could not be assigned to an auto parts retailer at some point in the not-so-distant future. Consequently, the restrictive use clause was not classified as overly restrictive, and did not tip the scales in favor of the debtor's attempt at invalidating its effectiveness.

Another significant outcome of the distinction between a lease that is *impossible* to assign and a lease that is just *economically difficult* to assign is found in public policy considerations.<sup>80</sup> Had the *Rickel* court upheld the de facto anti-assignment clauses in contention, due to the impossibility of finding other home improvement centers, the *Rickel* leases would be unassignable and inevitably revert back to the landlords. Consequently, the landlords would have obtained a windfall victory because they could re-let the properties to alternative tenants at market rates. The *Rickel* court wanted to avoid giving the landlords a deal that would exceed their original bargains.<sup>81</sup> By preventing the landlord from repossessing the tenant space, the court sought to safeguard the debtors' interests by making the lease values available to the creditors of the bankrupt tenants' estates.<sup>82</sup> On the

<sup>78</sup> See *id.*

<sup>79</sup> See *Trak Auto Corp. v. West Town Center, LLC*, 367 F.3d 237, 240 (4th Cir. 2004) (noting that there were seven auto parts retailers within three miles of the shopping center).

<sup>80</sup> See Harris Ominsky, *Shopping Center Lease Assignments in Bankruptcy After In Re Rickel Home Centers*, in THE SUBLEASE AND ASSIGNMENT DESKBOOK 177, 178–79 (Brent C. Shaffer ed., American Bar Association 2006) (discussing consequences of a tenant's bankruptcy on the tenant's landlord); see also Pamela Smith Holleman & Magdalena Ellis, *Solvent Shopping Center Tenants: Reexamination in Light of In Re Trak Auto Corp.: Part I*, 23 AM. BANKR. INST. J. 14, 64 (Dec./Jan. 2005) (comparing the holding of the *In Re Trak Auto Corp.* case with that of *In re Rickel Home Centers*).

<sup>81</sup> See Ominsky, *supra* note 80, at 180 (describing how the *Rickel* court shifted \$35,500,000 in potential assets from the landlords to general creditors by striking the restrictive use clauses in the tenant's leases); see also Holleman & Ellis, *supra* note 80, at 64 (explaining the public policy considerations behind the *Rickel* court's elimination of the anti-assignment clauses in *Rickel's* leases).

<sup>82</sup> See Ominsky, *supra* note 80, at 180 (comparing the impact of the tenant's assignment of the leases with the possible outcome the landlords could have achieved if the tenant did not declare bankruptcy); see also Holleman & Ellis, *supra* note 80, at 64 (contrasting the outcome of the *Rickel*

other hand, Trak Auto could have retained its properties for future assignment until market conditions became more economically viable.

*B. The Bankruptcy Court's ill-conceived precedent on standing for non-debtor tenants: Staples Inc. v. Montgomery Ward, LLC: A non-debtor's attempt at objection to an assignment is denied.*

The *Trak Auto* court established some of the powers given to a landlord in a bankruptcy proceeding, but another recent case dealt with a non-debtor tenant attempting to object to a lease assignment. In *Staples Inc. v. Montgomery Ward LLC*,<sup>83</sup> the debtor, Montgomery Ward, LLC, sold all or substantially all of its interests in real property to KRC Acquisition Corporation.<sup>84</sup> After a series of subleases, the property interest was transferred to Office Depot, Inc.<sup>85</sup> Staples, a non-debtor tenant in the shopping center, tried objecting to a fellow tenant's assignment of its lease.<sup>86</sup> Staples contended that it would have objected to the proposed sub-sublease to Office Depot because the proposed sub-sublease conflicts with Staples' lease provision granting it the exclusive right to operate as an office supply store in that shopping center.<sup>87</sup> In addition, Staples argued that the lease violated the tenant mix provision in section 365(b)(3)(D)<sup>88</sup> of the Code.<sup>89</sup> The court concluded that Staples did not have standing, and with almost no discussion of the matter whatsoever, quickly dismissed the notion that Staples could argue, under section 365 (b)(3)(D), that the lease assignment would disrupt the shopping center's tenant mix and would directly compete with the non-debtor's business.<sup>90</sup>

holding on the debtor with that on the debtor in *In Re Trak Auto*).

<sup>83</sup> 307 B.R. 782 (D. Del. 2004) (affirming the district court's denial of a Staples, Inc.'s objection to assignment of debtor's property interests to competitor Office Depot, Inc.).

<sup>84</sup> *Staples, Inc.*, 307 B.R. at 784 (determining that debtor Montgomery Ward, LLC's assignment of the lease to KRC Acquisition Corp. was valid).

<sup>85</sup> *Id.* (concluding that each subsequent transfer of debtor Montgomery Ward, LLC's lease was valid).

<sup>86</sup> *Id.* (finding Staples, a third party tenant, lacked standing to object to proposed sub-sublease to Office Depot).

<sup>87</sup> *Id.* (explaining that even if Staples did not lack standing to object to proposed lease, its objection would fail because the sublease allowed any lawful use of the premises).

<sup>88</sup> 11 U.S.C. § 365(b)(3)(D) provides: "For the purposes of paragraph (1) of this subsection . . . adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance— . . . (D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center."

<sup>89</sup> See *Staples, Inc.*, 307 B.R. at 784. "By its appeal, Staples contends that it did not receive notice of either the designation of Target or any proposed use of the TBA Outparcel." *Id.*

<sup>90</sup> See *id.* at 786–87. "In the alternative, assuming Bankruptcy Court had jurisdiction over this matter and that Staples has standing and is not otherwise barred from seeking relief, the Court would conclude that the Bankruptcy Court properly denied Staples' Motion." *Id.*

The court, however, erred in its reasoning regarding notice and misapplied sections 365(b)(3)(C) and (D). Section 1109 of the Code confers “upon part[ies] in interest” the right to “appear and be heard on any issue in a case under [Chapter 11].”<sup>91</sup> The Code does not define who qualifies under the statute as “party in interest,” but rather “the language of the statute and relevant treatises suggest that the term should be broadly construed and liberally applied.”<sup>92</sup> One such treatise states: “The general theory behind the section is that anyone holding a direct financial stake in the outcome of the case should have an opportunity . . . to participate in the adjudication of any issue that may ultimately shape the disposition of his or her interest.”<sup>93</sup> This Note contends that under the appropriate circumstances, third parties, such as Staples in this case, can and should be considered a “party in interest.” It is submitted that Staples had a significant “financial interest” in opposing Montgomery Ward’s assignment of its lease being that Office Depot is a competitor of Staples.

The reason given for why Staples did *not* have the right to be given notice of the assignment to Office Depot was that Staples’ lease was executed long after the debtor’s lease and that Staples’ lease contained a “carve-out.”<sup>94</sup> Furthermore, “the debtor’s lease provides that the exclusive provision did not prohibit any tenant under a lease existing on the date of [the Staples] Lease from using space occupied by it for its present permitted use or other permitted use if and to the extent Landlord does not have the right to prevent such change of use.”<sup>95</sup> The district court agreed with the bankruptcy court that if Staples were entitled to notice, then that would open a “Pandora’s box,” effectively allowing notice to be demanded by all co-tenants tenants in all other shopping centers where Montgomery Ward was a tenant and had assigned its lease.<sup>96</sup> Staples, however, is not a mere co-tenant like any other “co-tenant” as described to by the bankruptcy court. Both the non-debtor and the assignee are office supply stores, and accordingly the non-debtor has a strong interest in opposing the assignment. The court’s reluctance to agree with Staples that it was

<sup>91</sup> 11 U.S.C. § 1109(b) (2009).

<sup>92</sup> *In re Three A’s Holdings, LLC*, 364 B.R. 550, 561 (2007).

<sup>93</sup> COLLIER ON BANKRUPTCY, *supra* note 2, ¶ 1109.01[1].

<sup>94</sup> *Staples, Inc.*, 307 B.R. at 786.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

“If I hold that Staples was entitled to notice, I think one could imply that all other co-tenants in all other centers where Montgomery Ward was a tenant and assigned its lease to someone else should have been noticed. That could potentially place in jeopardy hundreds of assignments that have already been completed, that have resulted in hundreds of millions of dollars flowing into this estate. So I don’t want to open that Pandora’s box.”



entitled to notice of the assignment—for the reason that doing so might open Pandora’s box, allowing any tenant to subsequently demand notice—is a weak and unconvincing argument. Staples was denied a chance to object to an assignment that would almost certainly be damaging to its business. Other fellow tenants of Montgomery Ward that were not remotely affected by the assignment would have no reason to demand notice. Disinterested tenants with no cause of action who demand notice could possibly subject themselves to charges of a frivolous law suit.<sup>97</sup> If, however, another co-tenant was affected in a similar way as Staples was in this case, then such a suit could have real legitimacy and justification. The interest of these third parties should therefore be recognized as relevant concerns in a bankruptcy action.

Even assuming, *arguendo*, that notice and due process were not violated, the Court incorrectly applied sections 365(b)(3)(C) and (D). The court stated that Staples’ lease contained a “carve-out” that limited Staples’ exclusive right provision, and therefore disposed of Staples’ argument under section 365(b)(3)(C).<sup>98</sup> After all, if Staples’ lease allowed a potential competitor to join the shopping center then, in compliance with the requirements of section 365(b)(3)(C), there would be adequate assurance that the assignment of the debtor’s the lease would not “breach any . . . provision contained in any other lease[s].”<sup>99</sup> Once the court reached the conclusion that Staples’ had no operative exclusivity provision, the court made almost no analysis of a claim that the assignment disrupted tenant mix in violation of section 365(b)(3)(D).<sup>100</sup> The decision basically

<sup>97</sup> FED. R. CIV. P. 11(b) and (c) provide:

(b) Representations to the Court. By presenting to the court a pleading, written motion, or other paper . . . an attorney or unrepresented party certifies that to the best of the person’s knowledge, information, and belief, formed after an inquiry reasonable under the circumstances:

(1) it is not being presented for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation;

(2) the claims, defenses, and other legal contentions are warranted by existing law or by a nonfrivolous argument for extending, modifying, or reversing existing law or for establishing new law . . . .

(c) Sanctions.

(1) If, after notice and a reasonable opportunity to respond, the court determines that Rule 11(b) has been violated, the court may impose an appropriate sanction on any attorney, law firm, or party that violated the rule or is responsible for the violation.

<sup>98</sup> *Staples, Inc.* 307 B.R. at 786 (reasoning that since the Staples lease does not prohibit the assignment to another tenant, therefore Staples no longer had a legal interest in the proposed use of the retail space).

<sup>99</sup> 11 U.S.C. §365(b)(3)(C) (2009).

<sup>100</sup> *See Staples, Inc.* 307 B.R. at 787 (stating merely that the bankruptcy court recognized that

indicated that a tenant must have an exclusivity provision to be the basis of an objection to an assignment, pursuant to section 365(b)(3)(C), in order to raise a claim for disruption to the tenant mix, under section 365(b)(3)(D). The court improperly made subsection (C) into a prerequisite to be able to argue a tenant mix claim under subsection (D). This interpretation of the Code is flawed as a matter of statutory construction,<sup>101</sup> and the court's omission deprived Staples of an adequate evaluation of the important issue of disruption of the tenant mix. The *Staples* court erred on the issue of examining and evaluating the rights afforded to a non-debtor in a bankruptcy proceeding, highlighting the importance of addressing a non-debtors' rights for issues regarding lease assignments during a debtor's reorganization.

### III. ELEVATING THE SIGNIFICANCE OF A NON-DEBTOR'S INTEREST IN A BANKRUPTCY ANALYSIS

This part argues that in certain situations, bankruptcy courts should give adequate consideration to the effects that a debtor's decision might have on a non-debtor tenant when assigning a contract or seeking to violate a use restriction. Part III.A discusses the distinct characteristics of a shopping center and the importance of protecting all entities in a shopping center. Part III.B focuses on the legislative history that evidences an intention to give non-debtor tenants standing to object to an assignment or rejection. Part III.C examines other areas of bankruptcy law in which courts have given deference to a non-debtor instead of assisting a debtor in reorganizing. Part III.D offers suggestions about how the courts and the Code should approach instances involving a non-debtor tenant's opposition to a debtor-tenant's exercise of the rights afforded by section 365.

consideration of whether an assignment disrupts the tenant mix requires the court to determine the balance of rights between the parties, and that the Bankruptcy court examined these equities concluding that it would have overruled any objection by Staples to the proposed assignment and use, and that this court agrees with their conclusion).

<sup>101</sup> There is a settled rule of statutory construction that a statute should be read in a manner so that no part is superfluous, and every word has an operative effect. See *United States v. Nordic Village Inc.*, 503 U.S. 30, 35–36 (1992) (noting the complementary nature of the Code, and the several factors that favor such a construction). In this case, the court mistakenly prohibited an argument of a disruption to the tenant mix simply because there was no clause in the non-debtors lease that was breached as a result of the permitted assignment. Subsections (C) and (D) are completely separate provisions and therefore a tenant mix argument should be allowed under subsection (D), even if a non-debtor has no claim under subsection (C). See also *Dep't of Toxic Substances Control v. Interstate Non-Ferrous Corp.*, 99 F. Supp. 2d 1123, 1132 (E.D. Cal. 2000) (stating that a court must interpret the statute to give effect to all of its parts and that this includes giving effect to every word Congress used).

*A. Shopping centers are delicate enterprises and the Code must clearly address the rights of the non-debtor*

The unique nature of a shopping center necessitates an examination of the non-debtor's rights in a bankruptcy proceeding. Shopping centers have been referred to as "carefully planned enterprise[s]" in which the tenant mix "may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus, a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement."<sup>102</sup> Both the landlord and all tenants in a center have a vested interest in the entities located within the greater shopping center, and so competition amongst the tenants must be carefully monitored.<sup>103</sup> Too much competition hurts both the current tenants entrenched in the center and potential tenants that might want to eventually take a lease in the shopping center.<sup>104</sup> It would seem that if each tenant (and his/her actions) can have serious consequences on other tenants, then the interests of a non-debtor tenant should be given adequate consideration when a fellow tenant is introducing a new entity into a shopping center and possibly disrupting the equilibrium of the tenant makeup.<sup>105</sup> Given the case law and Congressional hearings that stress the

<sup>102</sup> H.R. REP. NO. 595, 95th Cong., 1st Sess. 348-49 (1977).

<sup>103</sup> See e.g., *In re TSW Stores of Nanuet, Inc.*, 34 B.R. 299, 303 (S.D.N.Y. 1983). "The evidence reveals that a good tenant mix in a shopping center benefits the landlord and the tenants as well."; Joseph Ooi & Loo-Lee Sim, *The Magnetism of Suburban Shopping Centers: Do Size and Cineplex Matter?*, 25 J. PROP. INV. & FIN. 2, 111 (2007), available at <http://emeraldinsight.com/Insight/ViewContentServlet> (noting that a great variety of shops in a shopping center creates a more pleasant environment for shoppers and therefore entices them to visit and stay longer).

<sup>104</sup> See e.g., *TSW Stores*, 34 B.R. 299 at 303.

In some categories, duplication is desirable . . . However, two competing stores selling general merchandise at close-out would not bring in any additional potential customers and would divide up the business between them. The other tenants in the shopping center would not benefit from this situation. Moreover, the existence of two competing stores selling general merchandise at close-out in a suburban shopping center would tend to limit the potential tenants who might be interested in leasing space in such a shopping center because there would be fewer categories of businesses to attract customers to the center.

Richard Brunelli, *The Ten Most Common Pitfalls in Strip Shopping Center Development*, REAL ESTATE FIN. J., (2007), available at [http://www.njretailrealty.com/news\\_info\\_1.html](http://www.njretailrealty.com/news_info_1.html). "A specialty center with a complimentary tenant mix will pull from a wider radius than a similarly sized property with a mixture of convenience tenants, which pull from a very short radius, and specialty shops. Centers with such a mixed personality are usually doomed for failure, with the specialty shops falling first." *Id.*

<sup>105</sup> See e.g., S. REP. NO. 98-65, at 33-35 (1983). "The interdependence among the tenants of a shopping center means that the bankruptcy of one tenant will seriously affect the other tenants." *Id.*

importance of the delicate balance of a shopping center, there is ample reason to give appropriate consideration to all relevant citizens of the shopping center.

*B. Legislative History indicates that power to object to an assignment should be granted to a non-debtor tenant*

In examining the legislative history of section 365(b)(3), strong evidence exists showing Congress had non-debtor tenants in mind when drafting that portion of the Code. Presumably in the event of a post-bankruptcy assignment, a landlord would be conscious of the potential effects of an assignment that might violate a provision contained in another one of its tenant's leases; however, in the event that the landlord does *not* exercise its right to object to an assignment, a non-debtor tenant should not be forced into a situation in which it is deprived of any of legal recourse. Congress was aware of the possibility that a solvent tenant could land in that situation and enacted legislation accordingly. In 1984, Congress amended sections 365(b)(3)(C) and (D) of the Code, deleting the word "substantially" from the provision previously requiring that assignment of the shopping center lease must not "breach substantially" certain restrictions.<sup>106</sup> Congress effectively made it easier to demonstrate that an assignment by a debtor-tenant was inappropriate because the party opposing the assignment only had to show a breach of a restriction, not a "substantial" breach. A Judiciary Committee report prior to the 1984 amendments highlights one of the motivations behind the change in the language:

Under the Bankruptcy Code, the shopping center and *its solvent tenants* may suffer serious economic harm or even business failure if the bankrupt tenant closes its store for an extended period of time or assigns its lease to a business which does not conform to the lease's use clause thus disrupting the shopping center's tenant mix . . . . [T]he bill strikes the proper *balance between the interests of the solvent*

Christina Gillotti, *Harm to Commercial Landlord's Reputation is Sufficient for Preliminary Injunction Issuance: Superior Court Finds Abuse of Discretion where Trial Court Ignores Imminent Harm to Reputation*, 3 LAW. J. 1, 13 (2001). "Moreover, he testified that the economic interdependence between the stores is a key part of the center's success." *Id.*

<sup>106</sup> See *In re Trak Auto Corp. v. West Town Center, LLC*, 367 F.3d 237, 243 (4th Cir. 2004) (stating that Congress responded in 1984 by amending the shopping center provisions to delete the word "substantially."); see also Ominsky, *supra* note 41, at 13 (commenting that the 1984 Congressional Amendments were made because the previous formulation of the Code made it too easy for the debtor to make lease assignments and avoid lease restrictions, resulting in problems with tenant mix and adversely affecting shopping centers).

*tenants of a shopping center and the insolvent tenants.*<sup>107</sup>

The significance Congress has given to maintaining the balanced tenant mix strongly indicates that if a non-debtor has reason to object to an assignment that might threaten the carefully planned tenant mix, then that tenant should be given its day in court.

*C. Heightened standards of review in other cases lend support to a more generalized view of the effect of assignment or rejection of an agreement or provision*

In at least two other areas of bankruptcy law, courts have recognized the unique nature of certain contracts necessitates an examination beyond the two parties to a contract. As discussed in Part I of this Note,<sup>108</sup> in *Mirant*, the Fifth Circuit instructed the district court to apply a stricter standard than the “business judgment” test when the contract at issue affected the public interest. Similarly in the Supreme Court case of *Bildisco*, the Court reasoned that rejecting collective bargaining agreements required a balancing of all equities.<sup>109</sup> Shopping center leases are also extremely unique and have wide ranging consequences on multiple parties. Accordingly, all factors, including issues raised by non-debtor tenants, should be evaluated. Furthermore, the inherent nature of a bankruptcy court strongly suggests that the interests of a non-debtor tenant could be potentially relevant in a court’s decision to reject or allow an assignment. Bankruptcy courts are courts of equity, so by definition their purpose is to balance issues of fairness in a bankruptcy proceeding.<sup>110</sup> Traditionally, the courts attempt to assist the bankrupt entity and provide the possibility of reorganization,<sup>111</sup> but it seems reasonable that in balancing fairness, non-debtors’ interests should be considered as well.

<sup>107</sup> S. REP. NO. 98-65, at 33–35 (1983) (emphasis added).

<sup>108</sup> See *supra* text accompanying notes 25–37.

<sup>109</sup> See *supra* text accompanying notes 18–25. It should be noted that subsequent cases to *Bildisco* have commented that the *Bildisco* ruling is not limited to CBAs, leaving the door open to the possibility that shopping center leases can be subject to the same type of analysis and treatment regarding third party interest. See, e.g., *In re FBI Distribution Corp.*, 330 F.3d 36, 44 (1st Cir. 2003), where the court noted that *Bildisco* “did not limit its discussion to collective bargaining agreements, but instead discussed general principles of executory contract law.” *Id.*

<sup>110</sup> See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1984). “Bankruptcy Court is a court of equity, and in making [the] determination [of what would constitute a successful rehabilitation of the debtors in the case] it is in a very real sense balancing the equities . . .” *Id.*; see also *Bank of Marin v. England*, 385 U.S. 99, 103 (1966). “There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction.” *Id.*

<sup>111</sup> *In re Jamesway Corp.*, 201 B.R. 73, 79 (S.D.N.Y. 1996). The “fundamental bankruptcy policy [is] allowing a debtor to realize maximum value from its assigned leases for the benefit of its estate and creditors.” *Id.*

In contrast to the bankruptcy court in *Staples*, the court in *In re Petur USA Instruments Co.*<sup>112</sup> recognized the damaging effect that rejection of a contract would have on a non-debtor party and made its ruling accordingly. The debtor, which marketed geotechnical instruments invented by one of its principals, sought to reject a twenty year licensing agreement with a closely held company formed solely for the purpose of marketing the debtor's products in Canada.<sup>113</sup> The court, in reviewing the debtor's decision to reject its contract with the Canadian company concluded that the debtor had "properly exercised its business judgment and that rejection could well create additional profits and aid in reorganization."<sup>114</sup> Nevertheless, the court declined to authorize the debtor's rejection of the licensing agreement because it found that granting the motion would result in the complete destruction of the non-debtor licensee's business and that damage to the licensee would be grossly disproportionate to any benefit derived by general creditors.<sup>115</sup> Despite the fact that the debtor would have benefited from rejecting the agreement, the court recognized how devastating that would be to the non-debtor and prohibited the rejection. The use of the broader-interest approach followed by courts regarding collective bargaining agreements and licensing agreements, should be made explicitly available and encouraged for issues pertaining to non-debtor tenants in a shopping center.

#### *D. Finding a Solution*

This note suggests that it is incumbent upon the Bankruptcy Code to specifically address the standing of non-debtor tenants in bankruptcy proceedings. The Code should find a balance between its goal of assisting a bankrupt entity in recovery on the one hand, and protecting solvent tenants from the actions of a tenant that is attempting to reorganize after filing for bankruptcy on the other. Non-debtors should be allowed to object to an assignment of a lease if it unduly burdens their own interest. If a bankruptcy court finds that a non-debtors interest would be unduly burdened by an assignment, then the non-debtor's interest should be factored into a court's decision of whether to allow the assignment of a debtor's lease. Similarly, the balancing test employed by the *Trak Auto*

<sup>112</sup> 35 B.R. 561, 563 (W. D. Wash. 1983).

<sup>113</sup> See *id.* at 562.

<sup>114</sup> *Id.* at 563.

<sup>115</sup> See *id.*

court for evaluating whether to enforce a use restriction<sup>116</sup> should tilt toward the side of enforcement of the restriction if a non-debtor's interest would be unduly burdened if a debtor was permitted to violate it. There should be a rebuttable presumption that if the landlord has not objected to a debtor-tenant's lease then the assignment does not unduly burden the non-debtor's lease, and the non-debtor is not entitled to standing to object to the assignment. This presumption in favor of the debtor recognizes the importance of assisting the debtor in reorganization, improving the chances that a bankruptcy court will approve an assignment if such assignment would be a useful means of reorganizing for the debtor. To overcome the presumption, the non-debtor must show that given the assignment, the presence of the newly assigned tenant would have had a substantial influence on the decision of whether to initially enter into the lease. This concept of a subjective standard by which to measure whether a particular problem in a situation affects the value or desirability of a piece of property is already recognized in Property law. In deciding whether a tenant may terminate its lease due to non-disclosure of a defect with the property, the level of the materiality of the defect is measured by whether the defect affects the subjective desirability of the property.<sup>117</sup> This same idea should be incorporated into the Code to measure the thrust and legitimacy of a non-debtor's objection to an assignment or rejection of a lease.

### CONCLUSION

The distinctive nature of a shopping center and the selectivity of the tenants chosen by the landlord create a delicate balance among shopping center co-tenants. A disruption of the tenant mix can drastically change tenants' expectations of its bargained-for lease arrangement. When a company files for bankruptcy, the Code is understandably concerned with

<sup>116</sup> See *supra* text accompanying notes 62–73 (explaining the balancing used by the court relating to the lease's restrictive use clause; balancing the reasonableness of the debtor's assignment against the harm or effect it would have on the landlord); Lisa S. Gretchko, *Last in Line: Debtor Beware! BAPCPA Affects Nonresidential Real Estate Leases, Too*, 25-8 AM. BANKR. L.J. 16, 55 (2006) (noting that Congress' codification of *Track Auto* is "very good news for shopping center lessors and the other tenants in the shopping center who wish to enforce the restrictive use provisions in their shopping center leases.").

<sup>117</sup> "It should be pointed out that whether the matter not disclosed by the seller or his agent is of sufficient materiality to affect the value or desirability of the property, and thus make operative the rule announced by the foregoing authorities, depends on the facts of the particular case." *Lingsch v. Savage*, 213 Cal. App. 2d 729, 737 (1963); see *Alfaro v. Cmty Hous. Improvement Sys. & Planning Ass'n, Inc.*, 171 Cal. App. 4th 1356, 1382 (2009). This case cites *Lingsch* for the proposition that "a seller of real property has a common law duty to disclose 'where the seller knows of facts materially affecting the value or desirability of the property . . .'"

helping the debtor reorganize to help it become a functioning business once again. Sometimes, however, that objective may be difficult to accomplish without crippling other businesses. In a carefully planned enterprise such as a shopping center, bankruptcy courts should be cautious of the effects a debtor's lease assignment might have on not only the landlord, but also fellow tenants. A non-debtor should have standing to object to a debtor's actions that have significant, adverse effects on the non-debtor's interests. The current economic downturn this country is facing has caused a sharp increase in bankruptcy filing and store closures.<sup>118</sup> As businesses try to navigate through the economic challenges that lie ahead, bankruptcy relief should remain a haven for struggling entities, but must be carefully administered to minimize resulting damage to their vulnerable non-debtor peers.

<sup>118</sup> See Chelsea Emery, *U.S. Strip Malls Suffer as Retail Tenants Disappear*, REUTERS, Nov. 25, 2008, <http://www.reuters.com/article/domesticNews/idUSTRE4AP07320081126> (stating that retail vacancy rates and bankruptcy filings have increased, and that the International Council for Shopping Centers estimates about 148,000 retail store closings this year); see also Michael Barbaro, *Retailing Chains Caught in a Wave of Bankruptcies*, N.Y. TIMES, Apr. 15, 2008, at A1, available at <http://www.nytimes.com/2008/04/15/business/15retail.html> (discussing how the credit crisis has caused many retail stores to close and file for bankruptcy, altering the tenant composition of shopping malls).



